



## **Baldwin Investment Management, LLC**

### **INVESTORS ON A HOT TIN ROOF**

To many investors, uncertainty and worry poison the atmosphere. A number of questions remain unanswered. Is inflation reappearing? Is U.S. economic growth about to slow down? Is stagflation, the dreaded disease of the 70s, making a comeback? The Federal Reserve Bank has declared that its actions going forward will be “data dependent” - which means the outlook looks uncertain and markets hate uncertainty. The result of this lack of confidence was that the stock market in short order gave back all of its performance since the beginning of the year. For several weeks investors have lurched from one economic indicator to the next searching for clues and so it seems to us that market volatility will be with us for some time.

During these five weeks of turbulence, one of the intriguing anomalies was that the Treasury bond market has been indifferent to the inflation fears ripping through global markets. Inflationary expectations, measured by the difference between TIPS (Treasury Inflation Protected Securities) and coupon bearing bonds fell from mid-May until recently, even after Mr. Bernanke issued a stern warning that increases in core inflation were “unwelcome developments”. Gold prices, which are often a hedge against inflation, also fell. So the credit markets, so often paranoid about inflation, have been surprisingly calm.

There have been other curiosities about the performance of the financial markets that have made it difficult to gauge the reason for the equity sell-off. Stock market investors are afraid that the Fed, anxious to prove its inflation fighting credentials, may tighten a notch or two too far, triggering a recession just as its prior interest rate increases of the past two years are beginning to take a toll on economic growth. Already there are indications that the housing market and consumer spending are cooling because of rate increases.

Yet, predictions about a sharp slowdown in growth are not fully reflected in other markets. Corporate bonds, for example, have outperformed equities, giving few indications that a economic down turn will raise default rates. Thomson Financial, a financial data complier, reports that upgrades to corporate earnings forecasts are still exceeding downgrades in every major stock market except for Britain's, which hardly indicates pessimism about the world economy. Earnings yields, too, are attractive compared with bond yields. In short, if you look at the reported and predicted numbers, you might wonder why people are as worried as they are.

Analysts say the selling of derivatives, as much as any other factor, exacerbated the drop in equity prices. Derivatives, first developed by Wall Street to provide insurance for market participants against drastic security price fluctuations, are used daily to provide

investors with highly leveraged exposure to trading positions. Unfortunately, as with anything which is highly leveraged, when the market goes against “your position” you must sell. With the stock market going “south”, many had to sell. As examples, the prices of gold and copper, darlings of the commodities boom, dropped like stones. Even those investors who made what they thought was a safe bet on a falling dollar have been nursing losses.

So, where do we stand with all this? We expect that there will continue to be stock market volatility for the next few months until there is greater clarity on anticipated Fed actions. There will be “feel good days” from what are likely to be good second quarter earnings reports, growing conviction that there is only benign inflation in the pipeline and thus, the Fed is closer to being finished with interest rate hikes. Offsetting the “feel good days” will be a periodic counter balance of Fed inflation jawboning and indicators that the U.S. economy is slowing resulting in more cautious company/analyst 2007 outlooks.

Interest rate increases over the past months are beginning to have their effect on U.S. economic growth most demonstrated by the housing market. We do not think, however, that the slowdown will be sharp because emerging economies, which are leading global growth remain resource intensive and continue to ramp up their infrastructure investment. So, international growth will help bolster the U.S. GDP (Gross Domestic Product) via stronger exports. We also think that because of weak labor unit costs (up just 0.3% year/year) and the slowing GDP, commodity prices should cool and thus the inflation outlook should be well contained. We believe it will be an economic soft landing.

We believe earnings growth for 2007 will be up – but not dramatically so. Margins have declined in healthcare and consumer areas. Home building is weak. Capital spending should remain strong, especially that for global infrastructure building. A positive counter-veiling trend is that the quality of earnings has improved. Firms are expensing options. Pensions are better funded and reported pension profits are lower than in the late 1990s. Lastly, write-offs have declined to an historically low level. The improved earnings quality should allow firms to increase dividends at a double digit pace, raising the payout ratio. With the recent extension of the 15% dividend and capital gains taxation to 2010, this is an important positive for shareholders.

At the end of the day, we believe that the market will do well in 2006. When will investors regain their confidence? Here are a few turning points which we think will be important:

- 1) When the Fed pauses in raising rates;
- 2) After the 2<sup>nd</sup> quarter earnings have been announced and they are better than expected;
- 3) In October companies should announce 3<sup>rd</sup> quarter earnings and will provide investors a positive outlook for 2007.
- 4) By early November the U.S. mid-term elections will be over.

So, by mid-November investors could be looking at a point when the Fed is done raising rates, the elections are over and earnings are generally decent. Assuming stock prices are roughly at today’s levels, investors will be looking at the S&P 500 with a PE ratio on a forward proforma EPS of 13 to 14 times, the lowest since 1995, despite interest rates being over 150 basis points lower and equity return taxation at about half the 1995 levels. We find this an attractive risk/reward situation.

## PREDICTIONS FOR 2006

## COMMENTS

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|---|---|
| 1. The dollar will continue to be strong (\$1.15-\$1.20/E)                        | Trading at \$1.25 - weaker than expected                        |
| 2. The Fed will stop raising interest rates in Q1 2006                            | Got this wrong - Raised rates in Q2 & expected to do so again   |
| 3. Republicans will lose seats but maintain control of Congress                   | Too early to tell, but still believe                            |
| 4. Troops will be drawn down in Iraq by 20%                                       | Not yet, in spite of recent political success in Iraq           |
| 5. Japan's economy will continue to gather steam                                  | Yes   |
| 6. Exchange Traded Funds (ETFs) will boom as an investment vehicle                | Yes, over \$300 billion now                                     |
| 7. More U.S. money will flow to international markets                             | Yes, foreign markets have been hot!                             |
| 8. Corporations will continue to hike dividends                                   | Yes   |
| 9. The U.S. Stock Market will do better than in 2005                              | Reversal in fortune Q2, but still predicting better performance |
| 10. Politics in Europe will remain confusing; a negative for equity markets there | Yes   |
| 11. Osama will be sold out and captured (we're <i>still</i> sticking with this!)  | Getting closer - reputed #2 Zarqawi is killed by US bombs       |

## A FINAL THOUGHT



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The reported numbers enclosed are derived from sources believed to be reliable. However, we cannot guarantee their accuracy. Past performance does not guarantee future results.

A list of our Proxy voting procedures is available upon request.

A current copy of our ADV Part II is available upon request or at [www.baldwinim.com/disclosure.htm](http://www.baldwinim.com/disclosure.htm)

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